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**AGENDA ITEM 22**

**TO: MEMBERS OF THE BOARD OF ADMINISTRATION**

**I. SUBJECT:** Special Review Recommendations and Implementation Plan

**II. PROGRAM:** Systemwide

**III. RECOMMENDATION:** Adopt Proposed Next Steps

**IV. ANALYSIS:**

At the December 2010 Board meeting, staff presented the findings and recommendations from the special review conducted by outside counsel to evaluate the use of placement agents in connection with CalPERS. This agenda item will present proposed implementation steps for each of the twelve recommendations made at the December meeting.

**Background**

The special review is being lead by Steptoe & Johnson LLP. Its mandate has been to determine whether the interests of the institution's members and beneficiaries have been harmed by of the use of placement agents or related activities, to pursue remedial measures addressing any such harm, and to make recommendations to prevent future harm. The work of the special review has been guided, in large part, by Article XVI, Section 17 of the California Constitution, as well as Section 20151 of the California Government Code, which provide that the CalPERS Board of Administration, its executive officers, and other employees are to discharge their duties solely in the interest of CalPERS participants and their beneficiaries, defraying reasonable expenses of administering the system, and investing with the care, skill and diligence of a prudent person. Applying these fiduciary standards to the review, these requirements have been summarized into two categories: fitness and fees. With respect to fitness, the special review has explored the actions of current and former CalPERS executives, staff and members of the Board of Administration as they related primarily to investment decisions and interactions with external managers and placement agents (or, in some cases, those placement agents and other CalPERS vendors). The special review has also examined qualitative fitness issues related to the external investment managers and consultants that serve CalPERS and support its investment process and objectives. The review has also investigated payments and things of value provided by external managers and their agents to CalPERS staff and Board members. With respect to fees, the special review has assessed apparent arrangements, financial and otherwise, between CalPERS and its external investment managers, and between those external managers and third-party placement agents. The review has also examined processes within the CalPERS Investment Office as they relate to investment decisions.

In addressing these issues, the special review has obtained over $200 million in fee concessions for CalPERS from external managers in various asset classes. Following those results, CalPERS investment staff later secured an additional $100 million in fee reductions from a number of other large external money managers. In the course of its work, the special review has collected over 70 million pages of electronic and paper materials from CalPERS, as well as its investment advisors, investment consultants, and others. The special review has also interviewed over 125 people, many of them more than once as additional information was uncovered.

While the mandate of the special review has not been to serve as law enforcement, federal and state agencies have been focused on whether and what violations of law may have occurred with regard to these placement agent issues and related activities for some time. In the course of its efforts on behalf of CalPERS, the special review has done additional work in assisting several law enforcement authorities, including the enforcement staff of the Securities and Exchange Commission, the California Attorney General's Office, and federal prosecutors in California. These federal and state investigators have made extensive requests for documents and other information, and CalPERS and the special review have complied in every respect, producing millions of pages of materials and providing regular reports on new issues as they developed. Those investigations are ongoing, and are expected to remain active for some time.

At the December 2010 meeting of the Investment Committee, the initial observations and recommendations of the special review were presented. (A copy of the written recommendations is attached as Attachment A.) At that time, the Board President directed staff to develop a proposed plan to implement the recommendations.

## **Proposed Implementation Plan**

The special review made twelve different recommendations to CalPERS. Each of these is presented in the following section with accompanying implementation steps.

1. Placement Agent and Gift Disclosures

Recommendation: CalPERS should continue to require investment managers and other vendors to comply with statutes and CalPERS regulations requiring regulation and disclosure of placement agents and disclosure of gifts.

Implementation:

CalPERS co-sponsored legislation requiring placement agents who solicit pension fund business to register as lobbyists. This legislation, AB 1743, which was enacted and signed into law last year, also bans placement agents from receiving fees contingent upon placing an investment for a money manager. CalPERS has also adopted regulations requiring the disclosure of placement agent arrangements and fees, as well as gifts or loans to past and current board members and staff, for prospective investment transactions and other contracts. The Investment Office and Operations Support Services Division have dedicated staff to review and analyze disclosures provided pursuant to these rules. CalPERS will ensure that these disclosures are known to decision makers and are part of the reporting responsibilities. No further implementation steps are recommended at this time.

2. Payment of Placement Agent Fees

Recommendation: CalPERS should adopt a policy prohibiting direct or indirect payment of placement agent fees from partnership or other trust assets.

Implementation:

CalPERS has adopted a regulation that requires new investment contracts and material amendments to include a provision that the fund manager "shall be solely responsible for, and CalPERS or a CalPERS [partnership or other investment vehicle] shall not pay (directly or indirectly), any fees, compensation or expenses for any Placement Agent" used by the manager. The Investment Office staff, with support from the Legal Office, is responsible for implementing this requirement. The Investment Office provides periodic reports on these disclosures.

Proposed Next Steps (Program): Staff recommends that the Office of Audit Services periodically audit compliance with this regulation and report its findings to the Finance and Investment Committees, as appropriate.

3. Institutional Risk Management

Recommendation: CalPERS should create a new position of Chief Risk Officer and create a permanent Risk Management Committee or assign the risk oversight function to the full Board.

Implementation:

In April 2009, the Board formed the Ad Hoc Risk Management Committee to oversee the enterprise risk management initiative. The Committee oversees the ongoing review and development of the enterprise-wide risk management framework and makes recommendations on any appropriate changes in enterprise risk management processes, governance, or related infrastructure to the full Board to ensure CalPERS meets or exceeds "best practice" for public pension system enterprise risk management. The Committee members are the Board President and the current chairs of all other Board committees.

As part of this initiative, CalPERS created a new enterprise risk management function and established a Risk Management Office. This function will be managed by the position of Chief Risk Officer, pending review and approval of the position level by the State Personnel Board. The system is currently recruiting for the position. The Chief Risk Officer will be responsible for managing risk intelligence for the enterprise, as well as compliance, privacy, information security, and disaster recovery. The Chief Risk Officer will have a “dotted-line” reporting relationship to the chair of the appropriate committee.

In September 2010, the CalPERS Ethics Helpline was launched. The new Helpline allows employers, employees, contractors, and the general public to report concerns about potential misconduct or inappropriate activities. The Helpline reinforces CalPERS efforts to ensure transparency, accountability, fairness, and integrity in the workplace. The Helpline is monitored by an external party, with a dedicated staff of call center specialists trained in handling reports from 120 countries. Reports can be submitted through a toll-free phone number or by submitting reports via a secure website 24 hours a day, 7 days a week, 365 days a year. The Ethics Helpline is part of the CalPERS Compliance Office.

Proposed Next Steps (Program): Staff recommends either of the following: a) the Board hear a standing risk management report from the Chief Risk Officer at the Board meeting or b) the Risk Management Committee become a standing committee. Staff further recommends that the Chief Risk Officer provide regular assurances of independence to either the Risk Committee or the full Board of Administration as presented to the Board at the January 2011 offsite.

4. Internal Audit Program

Recommendation: CalPERS should ensure that the Office of Audit Services reports regularly to the Board and adopt measures to improve manager accountability for responding to audit findings.

Implementation:

Beginning this year, CalPERS incentive compensation plans currently include a measure requiring audit findings resolutions within one year.

Proposed Next Steps (Program): Staff recommends that the Chief Auditor hold standing meetings on a monthly basis with the Chair of the Finance Committee and that the Chief Auditor meet periodically with the Board or Finance Committee in closed session to provide assurances of the independence of the function. Staff further recommends that audit findings remaining unresolved for six months from the date of the final audit report be reported to the Executive Risk Committee. When any audit findings remain unresolved for one year from the date of the report, the executive of the audited division should be required to affirmatively accept the risk of not implementing corrective action, and provide a written explanation as to why the acceptance of risk is the most appropriate disposition of the issue. Staff also recommends that this action be reported to the Risk Committee or to the Finance Committee as appropriate and to the Board. Finally, staff recommends that the Office of Audit Services conduct periodic audits of travel expense claims and payments.

5. Public Records Act Requests

Recommendation: CalPERS should train additional staff and place responsibility for responses with staff who were not involved in the creation of the underlying communications or documents.

Proposed Next Steps (Program): Staff recommends that the Executive Staff evaluate existing resources, staff, and protocols and report back to the Benefits and Program Administration Committee and the Board on enhancements in responding to Public Records Act requests.

6. Placement Agent Resolution Program

Recommendation: For partnerships and other managers that used placement agents, CalPERS should conduct a fitness review and strategic re-alignment of interests.

Implementation:

CalPERS, in conjunction with the Special Review, worked with several external investment managers to re-align their relationships with the system. These managers agreed to make fee and other economic concessions of over $200 million. Several investment managers paid placement agent fees in significantly smaller amounts.

Proposed Next Steps (Program): Staff recommends that the Investment Office, with support from the Legal Office, evaluate other investment managers who used placement agents and determine whether these firms have any fitness or fiduciary issues. This evaluation would occur over the next year and the results would be reported to the Investment Committee. There are a substantial number of firms that paid about $100 million in fees which would be subject to this type of review.

7. Fees and Carry

Recommendation: CalPERS should implement a program to reduce management fees and reduce or eliminate other fees charged by general partners and other external investment managers.

Proposed Next Steps (Program): CalPERS expects that management fees should be used to pay for the expenses of the management firm and not as a "profit center." This is one means to align the interests of the managing partner and the limited partners or members of the investment fund. Staff recommends that CalPERS continue working with the Institutional Limited Partners Association and the general partners to address these issues on an industry-wide basis over the medium term. In the short term, staff recommends that all new "special account" investments made by CalPERS be in funds whose managers are committed to this principle. Finally, staff recommends that the Investment Office provide quarterly status reports to the Investment Committee.

8. Modification of Investment Office Functions

Recommendation: CalPERS should separate the "dealmaking" and "monitoring" investment functions. The Investment Office should separate the negotiating function from the "monitoring and maintenance" functions within the office by assigning different staff to those two functions. Outside investment consultants should be permitted to fill only one of two roles on any investment: a) issuing prudence opinions or recommendations on the investment or b) performing a monitoring role after the investment has been made. Outside investment consultants should not be allowed to serve as external money managers for CalPERS.

Proposed Next Steps (Program): Staff agrees that there is a potential conflict of interest between the negotiating and monitoring functions for investment partnerships and similar vehicles. Staff recommends that the Investment Office perform an evaluation of existing protocols and resources and bring back to the Investment Committee proposed new policies or processes that address the issue.

9. Advisory Board/Annual Meeting Expenses

Recommendation: CalPERS should encourage general partners and other external managers to hold meetings at the offices of limited or general partners. CalPERS should preclude partnerships from paying these types of expenses out of fund assets and should preclude staff from attending meetings at other locations.

Proposed Next Steps (Program): Staff recommends that, in the near term, the system obtain greater transparency and accountability in the expenditure of partnership and LLC assets, including advisory board and annual meeting expenses. Staff further recommends that the Investment Office exercise judgment in selecting appropriate accommodations for these events. Over the medium term, staff recommends that the Investment Office negotiate with CalPERS partners to eliminate the expenditure of partnership or fund assets for these types of expenses. Further, CalPERS should work with the Institutional Limited Partners Association and the general partners to address these issues on an industry-wide basis over the medium term. Staff further recommends that, for sole account investments, the system require that investment managers conduct business meetings at their offices or the offices of CalPERS. Finally, staff recommends that updates be provided to the Investment Committee on a quarterly basis.

10. Modification of Civil Service Rules

Recommendation: CalPERS should sponsor legislation authorizing an expedited disciplinary process for portfolio managers and higher-ranking investment personnel.

Proposed Next Steps (Legislation): Staff recommends that CalPERS work with the State Personnel Board to draft potential legislation that allows for greater flexibility and speed in disciplining or terminating the appointments of persons compensated under Section 20098. Staff further recommends that the Governmental Affairs Office report back to the Benefits and Program Compensation Committee and the Board with analysis and recommendations.

11. Gifts and Travel

Recommendation: CalPERS should enhance ethics training and certification. CalPERS should continue the existing no-gift policy for staff and adopt a similar policy for board members. CalPERS should require external contractors to agree by contract not to make gifts in violation of CalPERS policies or other ethics rules and obtain contract termination rights for two or more violations.

Implementation:

CalPERS has initiated annual “working values” training sessions for all Form 700 filers. Attendance at this training is mandatory and includes an annual certification of compliance with ethics and similar rules. In 2011, this training will be provided for all CalPERS staff. CalPERS currently provides annual ethics training to its staff and board members and has a web-based training program as well.

Since November 2009, the staff has had a no-gift policy. When first adopted, there was some uncertainty because there were numerous questions from the staff. These questions have largely been resolved and the organization is now attuned to this policy.

State law currently regulates the acceptance of gifts and travel. For the calendar year 2011, a public official cannot receive a gift from a single source which exceeds $420. There is a separate prohibition against state officials and candidates from receiving gifts totaling $10 or more a month is provided or arranged by a lobbyist.

A gift is anything of value that provides a personal benefit, either tangible or intangible, to a public official or candidate for which the donor has not received equal or greater consideration. Gifts frequently include money, food, transportation, accommodations, tickets, and articles for household, office or recreational use. A gift also includes a rebate or discount in the cost of a product or service, unless the rebate or discount is made in the regular course of business to members of the public without regard to official status. Under specified circumstances, a gift made to an official's or candidate's spouse or children also may constitute a gift to the official or candidate.

Gifts aggregating $50 or more in a calendar year from a single source generally must be reported.

There are a number of exceptions from the basic definition of gift and items that are exempt from the gift definition are also exempt from any reporting or limitations placed on gifts. These include gifts returned to the donor or donated to a section 501(c)(3) organization within 30 days; gifts from certain relatives; informational material (e.g., books, reports, periodicals, etc.) that assist the recipient in performance of his or her official duties; gifts of hospitality received in an individual's home when the individual or a member of his or her family is present; free admission, refreshments and similar non-cash nominal benefits provided when the recipient is giving a speech or participating on a panel; tickets to attend fundraisers for campaign committees or other candidates or for section 501(c)(3) organizations; and gifts to the recipient's government agency. In addition, wedding gifts are not subject to the annual gift limit, but they are reportable.

State law also provides exceptions to the rules on gifts for certain payments for travel. Certain travel payments are nonetheless reportable by candidates and officials on their statements of economic interests. A variety of special rules apply to the receipt of travel expenses. Depending on the surrounding circumstances, such expenses may be prohibited, limited, reportable or exempt from coverage.

Proposed Next Steps (Policy/Regulation): The Board could consider changes to its governance policy that restrict the receipt of gifts beyond the limits imposed under existing state law. These could include lower gift limits, greater reporting requirements, or both. The Board could also consider a new policy providing that CalPERS will consider any investment manager or vendor violations of state gift rules or CalPERS policies when making a decision to enter into any new contract, contract amendment or investment commitment.

Proposed Next Steps (Legislation): The State Controller is proposing legislation that would lower the gift limit to $50 per year from each source. (A copy of the letter from the State Controller to the CalPERS Board President is attached as Attachment B.) As with other bills, the Governmental Affairs Office will evaluate this legislative proposal and bring it to the Board at a future meeting.

12. Revolving Door Prohibitions

Recommendation: CalPERS should sponsor legislation precluding staff and board members from working for placement agents or vendors for two years after leaving CalPERS when the vendor had at least $10 million in contracts that the staff or board member materially participated in awarding.

Implementation:

State law currently provides two separate post-employment restrictions on state officers and employees. First, the lifetime restriction permanently prohibits former state officials from being paid to appear in a proceeding involving specific parties in which the official previously participated.

Second, the one-year prohibition restricts specified state officials, for one year after leaving state service, from being paid to represent others before their former agency for the purpose of influencing the agency's decisions in specified proceedings.

In addition, the Public Employees' Retirement Law (PERL) contains a separate revolving door prohibition. It provides that an individual who has held the position of CalPERS board member, executive officer, general counsel, chief actuary, chief investment officer, investment officer or portfolio manager whose position is designated managerial, deputy executive officer, or assistant executive officer, shall not for a period of two years after leaving that position, for compensation, act as an agent or attorney for, other otherwise represent, any other person, except the state, by making any formal or informal appearance before, or any oral or written communication to CalPERS or any officer or employee of CalPERS, if the appearance or communication is made for the purpose of influencing administrative or legislative action or any action or proceeding involving the issuance, amendment, awarding, or revocation of a permit, license, grant, contract or sale or purchase of goods or property.

A summary of the existing rules is set forth in the following table:

| Persons Affected | Type of Ban | Duration |
|---|---|---|
| State Officials/ Employees | Paid Appearance In Same "Proceeding" | Lifetime |
| State Officials/ Employees | Paid Appearance Or Communication To Influence Former Agency | One Year |
| CalPERS Board Members, Executives, and Supervisory Investment Staff | Paid Appearance Or Communication To Influence Former Agency | Two Years |

Proposed Next Steps (Legislation): The State Controller is proposing legislation that would prohibit CalPERS board members and employees from accepting employment with a firm that had substantial contracts with CalPERS ($10 million and over) while they were with CalPERS. (See Attachment B.) Staff understands there are challenges in restricting post-employment opportunities. Staff recommends that CalPERS evaluate this legislation and work with the State Controller's Office on statutory language for employees which addresses these challenges and bring the proposed bill before the Board at a future meeting. The Board might also consider its position on the legislation as it applies to board members.

## Conclusion

The proposed next steps are designed to begin implementation of the recommendations of the special review. If approved, CalPERS staff will periodically report to the Board on the status of the implementation plan.

## VI. RESULTS/COSTS:

Costs and resource needs associated with the implementation of the special review recommendations have been allocated in the CalPERS 2010-11 Annual Budget.

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Attachments